No. 14,822

IN THE

United States Court of Appeals

For the Ninth Circuit

BLUMENFELD ENTERPRISES, INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for Review of the Decision of The Tax Court of the United States.

BRIEF FOR PETITIONER.

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BRIEF FOR PETITIONER.

OPINION BELOW.

The only previous opinion is that of The Tax Court of the United States promulgated January 20, 1955. The findings of fact and opinion of The Tax Court are reported at 23 T. C. 665 (R. 85-99).

JURISDICTION.

This appeal involves income taxes. By a notice of deficiency dated December 12, 1951 and addressed to the petitioner, the Commissioner of Internal Revenue determined a deficiency of $31,710.06 in the peti-

tioner's income taxes for the taxable year ended July 31, 1948 (R. 8-12). Petitioner filed a petition with The Tax Court of the United States on February 25, 1952, seeking a redetermination of the deficiency set forth in said Notice of Deficiency (R. 1), and petitioner filed an amended petition for such redetermination with The Tax Court on March 16, 1954 (R. 2, 4-8). The decision of The Tax Court was entered on March 23, 1955 and found a deficiency in income tax for petitioner's fiscal year ended July 31, 1948 in the amount of $31,405.31 (R. 99). The case was brought to this Court by a Petition for Review filed on June 13, 1955 (R. 100-101). The jurisdiction of this Court to review the aforesaid decision of The Tax Court is founded on Sections 7482 and 7483 of the Internal Revenue Code of 1954.

QUESTION PRESENTED.

During the taxable year ended July 31, 1950, a building owned by the plaintiff and known as the Tivoli Theatre Building became worthless and was demolished. The only issue before this court is whether petitioner's remaining cost for that building —which has been stipulated to be $132,284.42— (1) constitutes a deductible loss for the taxable year ended July 31, 1950 as the petitioner contends, or (2) may be recovered only by way of a depreciation or amortization allowance over the term of the lease, as the Commissioner contends. If a deductible loss was incurred by the petitioner in its taxable year ended July

31, 1950, that loss forms part of the petitioner's net operating loss carry-back from its said taxable year to its taxable year ended July 31, 1948 and is allowable as a deduction for income tax purposes for the taxable year ended July 31, 1948. There is no question as to the amount of loss or as to the availability or amount of the carry-back.

STATUTES AND REGULATIONS INVOLVED.

The statutes and regulations involved are set out in the Appendix, *infra*.

STATEMENT OF THE CASE.

The facts found by The Tax Court (R. 86-93) may be summarized as follows:

The petitioner is a California corporation with its principal office in San Francisco. It filed its corporation income tax returns for its fiscal years ended July 31, 1948, July 31, 1949 and July 31, 1950 with the Collector of Internal Revenue for the First District of California. It keeps its books and files its returns on the accrual basis (R. 86).

Petitioner's principal business is the operation of theatres. On or about March 10, 1946, petitioner purchased a fee interest in the so-called Tivoli property in San Francisco, which consisted of two adjacent, but separate, buildings. One of the buildings was known as the Tivoli Theatre Building and the

other as the Tivoli Office Building. The Theatre Building had been constructed in 1911. It had once been an opera house and a famous theatrical landmark in San Francisco. After petitioner acquired the Theatre Building, it was used for legitimate stage performances and for the presentation of motion pictures until June 2, 1947. By 1947, the district in which the theatre was located was no longer a desirable theatrical district; there were many bars in the area, and it had become a "tenderloin" district. Its location was away from the main theatre and entertainment district. From June 2, 1947 until October 6, 1949, the theatre was closed except for one three-day period in 1948 when it was rented for an outside theatrical showing. Petitioner closed the theatre in 1947 because it was losing money on its operation and found it economically impractical to keep it running. Petitioner thereafter had no intention of using the property as a theatre again (R. 86-87).

The Tivoli Office Building from the date of its acquisition by petitioner has been used as an office building, and a portion of the ground floor has been occupied by a cocktail lounge and bar (R. 87).

On October 6, 1949 petitioner, as lessor, and Harry Morofsky, as lessee, executed a lease of the Theatre Building for a term of twenty-five years at an aggregate rental of $420,000. In addition, the lessee agreed to pay all real estate taxes and charges levied against the property. The term of the lease was to start May 1, 1950, but the lessee was allowed to enter immediately for the purpose of beginning the neces-

sary alterations. It was contemplated that the property be converted into a public garage (R. 87-88).

Under the lease, the lessee was required to submit to petitioner for its approval plans for the remodeling of the building. In the latter part of 1949 preliminary and final plans for a five-story garage were prepared by the lessee and were approved by the petitioner. It was anticipated by the lessee that the cost of remodeling would be between $45,000 and $50,000 (R. 88).

When the lease was entered into October 6, 1949, neither the petitioner nor the lessee had any intention of demolishing the Theatre Building (R. 88-89).

In November 1949, the lessee submitted to the proper authorities of the City and County of San Francisco his plans for remodeling the Tivoli Theatre Building to convert it into a five-story parking garage. The authorities declined to approve the plans as submitted and insisted upon costly revisions of such a nature as to reduce substantially the amount and convenient usability of floor space for parking purposes. The cost of remodeling, if performed in accordance with the plans required by the authorities, was in excess of $125,000. It was not economically feasible to incur such cost, and the plans for remodeling the Theatre Building therefore had to be abandoned (R. 89).

The lessee then consulted another engineer who advised that the Theatre Building be demolished and that the area thus released be used for surface parking (R. 89).

On April 24, 1950, the lessor and the lessee entered into a letter agreement granting to the lessee an option to purchase the entire Tivoli property and giving the lessee permission to demolish the Theatre Building. That agreement reads in part as follows (R. 89-91):

> "1. The sale price is to be $350,000.00.
>
> 2. The sum of $25,000,00 is to accompany the sale agreement, in consideration for which the Purchaser shall have an option to conclude the deal within one (1) year.
>
> * * * * *
>
> 5. In the event the Purchaser does not conclude the purchase of the property within one (1) year, the $25,000.00 mentioned under No. 2 above shall remain with the Seller as additional lease deposit under that certain lease dated the 6th day of October, 1949, between Blumenfeld Enterprises, Inc., as lessors, and Harry Morofsky, as lessee, and shall be deducted from rentals at the end of the lease term. In consideration of this additional lease deposit, the lessors grant to the lessee permission to demolish the rear portion of the premises [Theatre Building] for the purposes conforming to said lease and further provided the lessee shall furnish to the lessor modified plans showing the proposed basement and ground floor development and shall secure from the lessors written permission for said development. All of the cost of demolishing and improving shall be at the lessee's sole cost and expense.
>
> 6. The Seller, as the lessor, expressly retains all of their rights under the aforementioned lease dated October 6, 1949, and makes no waiver of any of the conditions of said lease. * * *

> 7. In the event the Purchaser exercises his option to purchase within the one (1) year period, then he shall be given credit by the Seller for the net gross profit from the operation of all of the premises in the interim period. The Seller shall deduct from said rentals, taxes, insurance, utility costs and all other legitimate items of expense."

The $25,000 payment referred to above was made on May 1, 1950. When the letter agreement of April 24, 1950, was entered into, the lessee did not know whether or not he would exercise the option to purchase which was given therein (R. 91).

The "formal" agreement contemplated by the parties was executed on February 23, 1951. By its terms the time for exercise of the lessee's option was extended to expire on October 1, 1951, and the lessee was expressly required, notwithstanding anything in the lease of October 6, 1949, to the contrary, to clear the portion of the property formerly occupied by the theatre. The lessee was also expressly authorized to use the "premises and area for parking lot purposes by erecting a ramp for ingress and egress therefrom through the old entrance to the Tivoli Theatre." Pursuant to permission granted by the lessor in paragraph "5" of the letter agreement of April 24, 1950, the lessee had already demolished the Theatre Building on or about May 1, 1950, prior to the end of petitioner's fiscal year ended July 31, 1950 (R. 91).

There was at no time any understanding or plan, either by the petitioner or the lessee, to construct a

new building on the theatre property, and no building has ever been constructed thereon (R. 92).

On September 27, 1951, Harry Morofsky exercised the option granted by the agreements of April 24, 1950 and February 23, 1951, to purchase the Tivoli property, and on November 7, 1951, assigned his rights thereunder to the Hertz Shoe Clinic, Inc., a corporation. That corporation is now the owner of the Tivoli property (R. 92).

In its income tax return for its fiscal year ended July 31, 1950, the petitioner claimed as a deduction a loss on the demolition of the Tivoli Theatre Building in an amount representing the undepreciated balance of the cost of that building as shown on petitioner's books,* resulting in a net operating loss of $82,818.32 for its fiscal year ended July 31, 1950. Petitioner claimed a net operating loss carry-back of $82,818.32 from its fiscal year ended July 31, 1950 to its fiscal year ended July 31, 1948, and made application for a tentative carry-back adjustment under Section 3780 of the Internal Revenue Code of 1939. A tentative allowance was made to petitioner under this section in the amount of $30,803.55 (R. 92-93).

In his determination of petitioner's deficiency for the fiscal year ended July 31, 1950, respondent has disallowed the deduction claimed upon the demolition of the Tivoli Theatre Building, and in his notice of deficiency to petitioner for its fiscal year ended July

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*It has been stipulated that the total unrecovered cost of the Theatre Building and its improvements as of the date of demolition was $132,284.42.

31, 1948, respondent has not allowed the net operating loss deduction claimed by petitioner (R. 93).

STATEMENT OF POINTS TO BE URGED.

The petitioner's statement of points is set out in full on pages 153-154 of the Record. Simply stated, petitioner maintains that it suffered a deductible loss in its taxable year ended July 31, 1950 when during that year the petitioner's Tivoli Theatre Building became worthless and was demolished, that said loss became part of petitioner's net operating loss carry-back from its taxable year ended July 31, 1950 to its taxable year ended July 31, 1948 and is allowable as a deduction for income tax purposes for its taxable year ended July 31, 1948. The Commissioner disallowed the loss claimed by the petitioner in its return for its taxable year ended July 31, 1950 on the following ground (R. 23):

> "The unrecovered cost of the building voluntarily demolished in connection with securing the lease is held to be a capital cost of the lease amortizable over the life of the lease. The claimed abandonment loss is therefore disallowed."

The only question, then, is: May the taxpayer deduct the undepreciated cost (its remaining basis) of a building demolished in its fiscal year ended July 31, 1950 during that year (as it did in its return) or must it deduct such remaining cost by way of amortization over the twenty-five year term of the lease (as the Commissioner contended in his Notice of Defi-

ciency and The Tax Court in its opinion in effect decided)?

ARGUMENT.

INTRODUCTION AND SUMMARY.

The opinion of The Tax Court misstates the issue, and that misstatement is at the basis of its erroneous decision. It regards the issue as being whether the demolition of the Tivoli Theatre Building in the fiscal year of the taxpayer ended July 31, 1950, resulted in a deductible loss to the taxpayer. It reaches the conclusion that no deductible loss was incurred as a result of the demolition, and that to allow the deduction would be to give the taxpayer "a *windfall* that Congress never intended" [Emphasis supplied]. (R. 99). The Tax Court's conclusion that there was no loss is not true, and its conclusion that to allow a deduction would result in a "windfall" is equally untrue. The error of The Tax Court can be readily demonstrated. In the first place, at the time of its demolition the building concededly had an unrecovered cost or basis of $132,284.42 (R. 92). There has never been any question but that this amount may be deducted. The only question is whether the amount may be deducted in the year of demolition or whether it must be spread over the term of the lease. The Commissioner, in his notice of deficiency for the fiscal year ended July 31, 1950 (the year of the demolition) states that the amount is to be recovered by amortization over the twenty-five year term of the lease (R. 22-23). The taxpayer

contends that this amount may be deducted in full in the year of the demolition of the building.

Clearly, during the taxable year in question, the building became worthless (R. 123, 138). Plainly, from an every day "common sense" viewpoint there was a "loss" either when the building became worthless or when, later in the same taxable year, it was demolished. Before the demolition the taxpayer had a building with an unrecovered basis thereof of $132,284.42 (R. 92). After the demolition, the taxpayer had no building. Taxpayer submits that the amount of its cost basis constitutes a deductible loss in the year of worthlessness and demolition, and that the taxpayer should not be required to amortize that cost over the term of a lease entered into not with the thought of demolishing the building but with the intention of utilizing it.

The general rule is that a loss on the demolition of an old building is deductible in the year of demolition. To this rule, only three exceptions have been recognized. The exception here relied upon by the Commissioner and by The Tax Court is that where an old building is demolished in order to obtain a lease, the undepreciated cost of the old building constitutes a cost of obtaining the lease. Hence, the unrecovered cost of the building is amortizable over the terms of the lease and is not deductible in full in the year of demolition. However, this exception is not applicable here. Permission to demolish the building was *not* given to the lessee in order to obtain the lease; the lease was executed at a time when

there was no intention to demolish the building. Unexpected events occuring after execution of the lease led to the demolition. The agreement giving the lessee permission to demolish the building did not give to the taxpayer a more valuable leasehold, and hence it cannot be said that taxpayer secured anything in exchange for the permission granted the lessee to demolish the building. Furthermore, the building actually became worthless during the taxpayer's fiscal year ended July 31, 1950, the year in which it was demolished and a deductible loss should be allowed to the taxpayer in that year on that ground irrespective of the lease.

I. THE GENERAL RULE IS THAT A LOSS ON THE DEMOLITION OF AN OLD BUILDING IS DEDUCTIBLE IN THE YEAR OF DEMOLITION.

The general rule is that a loss on the demolition of an old building is deductible in the year of demolition, whether or not such removal is "incident to renewals and replacements", *Dayton Co. v. Commissioner* (CA 8, 1937), 90 F. 2d 767; *Ingle v. Gage* (W D N Y 1931) 52 F. 2d 738; *Work Clothing Corp.* (1949) 8 TCM 506. The reason for the rule is simple. Before the demolition, a taxpayer owns a building with an undepreciated cost to him, in this case, of approximately $132,000. After the demolition, he no longer has the building. Unless he may deduct his undepreciated cost or unless he has in the transaction acquired other assets to which this cost can be applied, he will be penalized by the loss of his cost or basis of $132,000.

As this Court states in *Young v. Commissioner* (CA 9, 1932) 59 F. 2d 691:

> "* * * There can be no question that where a land owner finds it necessary to remove structures unsuitable for further use, he may have a reduction from gross income for the loss."

At least until the decision of The Tax Court in the instant case, the courts had recognized only three exceptions to the general rule that demolition losses are deductible in full in the year of demolition, and, in fact, not all courts have recognized all of these three exceptions.

The first and clearest of these exceptions is stated in Section 29.23(e)-2 of Treasury Regulations 111 as follows:

> "When a taxpayer buys real estate upon which is located a building, which he proceeds to raze with a view to erecting thereon another building, it will be considered that the taxpayer has sustained no deductible loss by reason of the demolition of the old building, and no deductible expense on account of the cost of such removal, the value of the real estate, exclusive of old improvements, being presumably equal to the purchase price of the land and building plus the cost of removing the useless building."

This exception is obviously inapplicable here. The property in question was not purchased with a view of demolishing the building but with the view of using it as a theatre building, and it was so used for a number of years. The possibility of demolishing the

building was not even considered until shortly before the actual demolition in 1950, some four years after the taxpayer's acquisition of the property in question.

Some cases hold that the exception contained in the regulations is the only exception to the general rule, *Union Bed & Spring Co. v. Commissioner* (CA 7, 1930) 39 F. 2d 383; *Hotel McAllister, Inc. v. United States* (D. Fla. 1933) 3 F. Supp. 533; *Wearley v. United States* (N. D. Ohio 1943) 32 AFTR 1761, 43-2 USTC ¶9545. However, some courts have engrafted a further exception upon the general rule, holding that if a building is demolished in order to make way for the erection of a new structure, even though there was no such intent at the time that the property was acquired, the demolition loss is considered part of the cost of the new building and is to be depreciated over its life, *Commissioner v. Appleby* (CA 2, 1942) 123 F. 2d 700, *aff'g.* (1940) 41 BTA 18. This exception is likewise inapplicable here; neither the taxpayer nor its lessee has ever had any intention of replacing the old building with a new building, and in fact no such replacement has ever been made.

The third exception to the general rule applies where an old building has been demolished in order to obtain a lease, generally with the lessee's agreement to put up a new building. In these cases, the demolition loss has frequently been held to be a cost of obtaining the lease, amortizable over the life of the lease, *Young v. Commissioner* (CA 9, 1932) 59 F. 2d 691. It is this exception that the Commissioner of In-

ternal Revenue claimed was applicable here (R. 22-23), and The Tax Court also relied upon this exception although it gave other reasons for denying the claimed loss. However, as will be explained more fully below, the building was not demolished in order to secure a lease; the lease was entered into on October 6, 1949, at which time (and prior thereto) no consideration whatsoever had been given to demolishing the building.

The Tax Court states (R. 96) that a demolition loss "has been disallowed in a variety of other circumstances, where no actual loss was suffered as a result of the demolition", and then cites seven cases purportedly setting forth the "variety of other circumstances" in which a demolition loss had been disallowed. However, all seven of the cases cited are examples of situations in which, in order to obtain an advantageous lease, a lessor either demolished a building or permitted his lessee to do so, and in all of them the court (or Board of Tax Appeals) merely disallowed the claimed demolition loss on the ground that the demolition was a cost of securing the lease. Hence, unless this case falls within one of the recognized exceptions to the rule permitting deductions of demolitions, taxpayer's demolition loss constitutes a deductible loss in its fiscal year ended July 31, 1950.

II. THE TAX COURT'S REASONS FOR FAILING TO FOLLOW THE GENERAL RULE ALLOWING THE CLAIMED DEDUCTION ARE WHOLLY INADEQUATE.

The Tax Court denied the deduction in the year of demolition of the full amount of the loss on the following grounds:

1. The petitioner in fact sustained no loss since "The term of the lease extended substantially beyond the remaining useful life of the building, and * * * the lessee's obligations under the lease were in no way curtailed upon removal of the building". (R. 97.)

2. Permission to demolish the theatre was given by an agreement "that looked primarily towards the sale of the property", and "In such circumstances the only loss allowable would be one at the time of sale equal to the excess, if any, of the adjusted basis over the sales price." (R. 97.)

3. "From the lessor's point of view the building was being replaced by an advantageous lease and therefore no deductible loss is allowable * * * [since] the unrecovered cost of the razed building is to be treated as part of the cost of the lease." (R. 98.)

4. "* * * petitioner did not in fact sustain a loss as a result of the destruction of the theatre building, and * * * to allow the claimed deduction here would be to give petitioner a windfall that Congress never intended." (R. 99.)

There is no merit in any of these grounds.

A. The fact that the term of the lease was longer than the expected useful life of the building is of no importance.

The Tax Court opinion first states that since the lease of the Tivoli Theatre Building (twenty-five years) was in excess of the remaining useful life of the theatre building at the time of the lease (about sixteen years), no loss was sustained upon the demolition of the building (R. 97). The Court's view apparently is that wherever property is leased for a term longer than its expected useful life, no loss can be taken at any time on the demolition of such property.

This reasoning of The Tax Court assumes that the lessee will actually be able to pay the rent for the life of the lease, that the lease will continue for its entire term, and that no improvements could be made to the building which might lengthen its life, all of which are matters of speculation. Actually the instant lease ended within two and a half years, in September 1951 (R. 92). When a building with an expected sixteen years of remaining life is leased for twenty-five years, it is uncertain whether or not the lease will actually last that long and whether or not the building will be of any value at the termination of the lease (whether termination occurs at or prior to the end of the fixed term). Where, as here, the building is demolished because of worthlessness prior to termination of the lease, it becomes clear that the lessor will never get the building back and that he has incurred the loss at the time that the building is demolished. Certainly, the fact that if the building

had not been demolished, the lessor might or might not have recovered a building of any value at the termination of the lease is no reason to deny the deduction where the building is demolished.

Furthermore, if The Tax Court is correct in its view that where the term of a lease extends beyond the useful life of a building, the taxpayer incurs no loss on demolition of the building, it necessarily follows that the lessor in such a case would lose his right to depreciation over the useful life of the building and would be permitted only to amortize the remaining cost of the building over the term of the lease. That very argument was made by the Commissioner and rejected by the Court of Appeals for the Sixth Circuit in *Lamson Bldg. Co. v. Commissioner* (CA 6, 1944), 141 F. 2d 408. In that case, the taxpayer leased certain improved real property for a 75-year term. The useful life of the building was considerably less than the term of the lease. The Court of Appeals for the Sixth Circuit nevertheless allowed depreciation to the lessor over the shorter useful life of the improvements rather than over the 75-year term of the lease, as determined by the Commissioner.

At page 410 of the opinion the Court of Appeals stated:

> "There is intrinsic fairness in basing depreciation upon the single standard of useful life, if we are right in concluding that such standard is, under the regulations, alone applicable. Should the tenant default and the lessor repossess the property, he has not been deprived of his full measure of depreciation allowance, and in the case

> of a short term lease, the Treasury is not deprived of revenue by an inordinate depreciation rate during the term of the lease. On the other hand, if a new building replaces the old, after invested capital has been fully recovered by depreciation deductions, its value or so much of it as remains after the expiration of a long term lease, is doubtless a gain to the lessor under applicable rules."

If, as the Court of Appeals held in the *Lamson Bldg. Co.* case, a lessor is allowed depreciation on the basis of the useful life of the improvement even though it may be shorter than the term of the lease, it would certainly follow that the lessor should be allowed a loss incurred on the demolition of the improvement prior to the expiration of the term of the lease, at least where, as here, the demolition of the improvement was not contemplated when the lease was entered into.

The case of *Albert L. Rowan* (1954), 22 T.C. 865, the only one cited by The Tax Court upon this point, is obviously inapplicable here. There, the taxpayer inherited a one-third interest in property upon which a building had been constructed by the lessee under a 66-year lease, without cost to the lessor. The term of the lease extended beyond the useful life of the building. The Tax Court denied taxpayer's claimed deduction for depreciation on the building. The Tax Court pointed out that:

1. The decedent (the original lessor) had no investment in and hence no basis for the building. The

annual depreciation deductions on the cost of the building were being granted to the lessee. Granting the depreciation deduction to the taxpayer would be allowing the same deduction to two different taxpayers.

2. Upon expiration of the lease, the taxpayer would receive the land together with the building. The property might then be worth more than its value when taxpayer acquired his interest therein (the date of decedent's death). Hence, it was not clear that the taxpayer was suffering a diminution in the value of his property of the type to be recovered through a depreciation allowance.

Neither of these factors is present in this case. Here, the petitioner had an investment in and a cost basis (acquired by purchase) for the Tivoli Theatre Building. Depreciation was claimed by and allowed to the taxpayer-lessor, and the lessee had no claim thereto. There is no question here as to whether or not the *lessee* is entitled to the loss; no problem here exists as to whether allowing the deduction to the instant taxpayer would be permitting a double deduction.

With respect to the second factor relied on in the *Rowan* case, the facts of the instant case likewise differ from those of that case. Here, it was obviously impossible that the taxpayer would receive the building intact at the end of the lease; the building had been demolished, and the lessee was under no obligation to restore it or erect a new building. Here, it is unnecessary to await termination of the lease to de-

termine whether a loss was sustained by the taxpayer upon demolition of the Tivoli Theatre Building. The taxpayer clearly incurred a loss in the year of demolition, and the loss should be allowed as a deduction in that year.

B. The fact that permission to demolish the building was granted to the lessee in an option agreement is of no significance.

The second reason advanced by The Tax Court for refusing to allow the claimed deduction is that (R. 97):

> "* * * Permission to demolish the theatre building was given to the lessee in the letter agreement of April 24, 1950. That agreement was one that looked primarily towards the sale of the property. Of course, there was no assurance at that time that the sale would go through, but the option was in fact exercised and the sale did in fact take place, as contemplated, although there were modifications in some of the details. In such circumstances the only loss allowable would be one at the time of sale equal to the excess, if any, of the adjusted basis over the sales price. See Oscar K. Eysenbach, 10 B.T.A. 716, 722."

The fact that the contract which gave the lessee permission to demolish the Tivoli Theatre Building also granted it an option to purchase the underlying land and the office building has no bearing on the issue of whether a deduction should be allowed to the taxpayer as a result of the demolition of the theatre building. The Tax Court gives no explanation whatsoever of how this factor could possibly be material. The Tax Court found as a fact (R. 91) that: "When

the letter agreement of April 24, 1950, was entered into, the lessee had not determined whether he would exercise the option to purchase which was given therein." As a matter of fact, the option to purchase was not exercised by the lessee until September 27, 1951, in the taxpayer's fiscal year ended July 31, 1952, well over a year after the demolition of the building (R. 92). Hence the gain or loss on the sale of the land underlying the Tivoli Theatre Building and of the Tivoli Office Building and the land thereunder was not a closed transaction until September 1951 and the gain or loss therefrom was not includible in taxpayer's income until its fiscal year ended July 31, 1952. On the other hand, the taxpayer had irretrievably parted with the Tivoli Theatre Building when it was demolished during its fiscal year ended July 31, 1950. The Tax Court cites no authority to support the proposition that taxpayer's demolition loss incurred in its 1950 fiscal year should be postponed or held in suspense until it was determined a year and a half later whether or not the lessee would purchase the land which that building had formerly occupied, together with the adjacent Tivoli Office Building.

If The Tax Court is arguing in effect that the agreement granting the lessee permission to tear down the Theatre Building and giving him an option to purchase the remainder of the property was in essence one calling for the sale of the Theatre Building, then the loss on the Theatre Building constituted a deductible ordinary loss to the taxpayer under Section

117(j) of the Internal Revenue Code of 1939. Such loss would be deductible in taxpayer's fiscal year ended July 31, 1950, since this was a transaction independent of the option to purchase the remainder of the property, which was ultimately exercised in the taxpayer's fiscal year ended July 31, 1952. The taxpayer had a basis of $132,284.42 for the Theatre Building at the time of its demolition and it received nothing that it did not have before in return for giving the lessee permission to demolish the building.*

The only case here cited by The Tax Court—*Oscar K. Eysenbach* (1928) 10 BTA 716—is readily distinguishable from the instant case. In that case, the owners of a piece of improved real estate leased the property for a 99-year term. Under the terms of the lease, the lessee was to raze an old brick building (which had an undepreciated cost of $41,666.67) and to erect thereon a new building to cost not less than $100,000. The lessee took possession and razed the old building. He commenced erection of the new building, but after erecting part of it and having expended thereon between $57,000 and $58,000, he defaulted on

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*It might be argued that the $25,000 received by the taxpayer as an additional lease deposit and as consideration for the option (R. 90-91) was also received from the lessee as consideration for the Theatre Building but in that event, the unrecovered basis for the building ($132,284.42) less the consideration given therefor ($25,000) or $107,284.42 constitutes an allowable loss to the taxpayer under Section 117(j) of the Internal Revenue Code of 1939 for its taxable year ended July 31, 1950. Taxpayer submits that the $25,000 was not consideration for the building, and that whether the transaction is considered as a sale of the building to the lessee or as a demolition loss, the full amount of the basis constitutes a deductible loss to the taxpayer in the year of sale or demolition.

the lease. The taxpayer, one of the lessors, claimed a loss upon the razing of the building. The Board of Tax Appeals denied the claimed loss. In the *Eysenbach* case, permission to raze the old building had been given to secure a lease, a factor not here present. Furthermore, the old building, with an undepreciated cost of $41,666.67, had there been replaced by a partly completed building upon which the lessee had expended over $57,000. In that case then, there was merely a substitution of assets; the old building was demolished either in return for the lease or in return for the new building which the lessee had undertaken to build. There was thus no economic or tax loss. On the other hand, in the instant case, the permission to demolish was not given in order to secure a lease; the lease had already been secured. Furthermore, no new building or other asset replaced the old building. Unlike the taxpayer in the *Eysenbach* case, the taxpayer in the instant case realized a physical and economic loss in the taxable year of demolition, namely, its fiscal year ended July 31, 1950.

C. The building in question was not demolished in order to secure a lease.

The Tax Court's third ground for disallowing the claimed deduction is that "the removal of a building in connection with obtaining a lease on the property is regarded as part of the cost of obtaining a lease." (R. 97). It is true that where an old building has been demolished in order to obtain a lease (usually with the lessee's agreement to put up a new building), the demolition loss has been held to be a cost of obtain-

ing the lease, amortizable over the life of the lease. Here, however, that exception to the general rule that demolition losses are deductible in the year of demolition is not applicable.

1. Permission to demolish the building was given not in the original lease but in a subsequent modification.

In the instant case, permission to demolish the building was not given to the lessee in order to secure the lease. The lease was entered into on October 6, 1949, at which time no consideration whatsoever had been given to demolishing the building (R. 88-89). Rather, it was the intention of both the lessor and the lessee that the building would be retained and converted into a garage. The refusal of the San Francisco City authorities to permit the conversion of the building into a garage in the manner planned, which occurred after the lease was entered into (R. 89), gave rise to the plan to demolish the building. The taxpayer granted the lessee permission to demolish the building by a letter agreement dated April 24, 1950, five and one-half months after the lease was entered into (R. 89-90). The original lease was in no wise contingent upon demolishing the building. Hence, it cannot be claimed that the building was voluntarily demolished in order to secure a lease, and that the undepreciated cost of the building should therefore be amortized over the term of the lease.

2. The lease modification did not give taxpayer a more valuable leasehold.

It has been held that where an old lease was cancelled and a wholly new lease at a higher rental en-

tered into in return for the lessor's permission to the lessee to demolish the building, the undepreciated cost of the building was not deductible in the year of demolition, but was amortizable over the term of the lease, *Myer Dana* (1934) 30 BTA 83, *acq.* XIII-1 CB 5.

However, the instant situation is wholly different. Here the demolition of the building did *not* result in the taxpayer's obtaining a longer or more favorable lease in any manner. Here no new lease was entered into. The letter agreement of April 24, 1950, under which the lessee was given the authority to demolish the Tivoli Theatre Building did not change the terms of the original lease. That agreement specifically states:

> "6. The Seller, as the lessor, expressly retains all of their [sic] rights under the aforementioned lease dated October 6, 1949, and makes no waiver of any of the conditions of said lease, including but not limited to the $10,000.00 guarantee by Mr. Herman Hertz."

The agreement of April 24, 1950, gave *to the lessee* an option to purchase the entire Tivoli property (including both the Theatre Building and the Office Building). The granting of this option was a detriment and not a benefit to the taxpayer and cannot be said to be an asset received by the taxpayer in exchange for its permission to demolish the property. The lessee was given a one year period in which to exercise the option, and the agreement of April 24, 1950, called for the lessee to deposit $25,000 with the

taxpayer. This sum of $25,000 was the only consideration which can conceivably be argued was received by the taxpayer for granting the permission to demolish. However, this amount of $25,000 did not become the property of the taxpayer outright in exchange for the permission to demolish; rather, it was to be applied against the purchase price if the option was exercised, and if the option was not exercised it was to constitute merely an additional lease deposit.*

Again, it should be borne in mind that the general rule is that demolition losses are deductible, and that the doctrine that such losses are not deductible when incurred to secure a lease is an exception to the general rule. The basis for this exception is that there has been a substitution of assets (a leasehold for a building) rather than a demolition of the building without receiving any consideration therefor. The Courts have clearly stated that such is the basis for the exception. In *Anahama Realty Corp. v. Commissioner* (CA 2, 1930) 42 F. 2d 128, cert. den. 282 US 854, for example, the Court said:

> "* * * The removal of the buildings was a part of the cost of acquiring the lease and with it came the obligation of the tenant to pay the rent. The cost of acquiring an asset cannot be regarded as deductible as a loss or business expense for the year in which it is paid or incurred. * * * There

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*Even if it could be said that the $25,000 was received by the taxpayer in exchange for its permission to the lessee to demolish the Tivoli Theatre Building, that transaction would certainly constitute a taxable event upon which, under Section 117(j) of the Internal Revenue Code of 1939, an ordinary loss would be allowable to the petitioner which would enter into the net operating loss carry-back.

was a substitution of assets rather than a loss sustained in the destruction of the buildings."

In *Young v. Commissioner* (CA 9, 1932) 59 F. 2d 691, cert. den. 287 US 632, this Court said:

> "* * * On the other hand, where he [the lessor] finds it advantageous to remove substantial buildings in order to secure a lease which will result in his having erected on his property a new building, without money outlay on his part for its construction, and to have assured a large rental income for a long term of years, it would seem just and reasonable that the value of the buildings removed be charged as a contribution to the cost of securing his lease, and as a part of the investment then made for that purpose."

See also, *Smith Real Estate Co. v. Page* (CA 1, 1933) 67 F. 2d 462 (discussed *infra* pages [36-37]).

In the instant case, we do not have the substitution of assets which is necessary to deny the deduction of the demolition loss and require amortization over the term of the lease.

The situation is analogous to that of repairs. In the words of the regulations "* * * incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, * * *" may be deducted as an expense, whereas if repairs arrest deterioration and appreciably prolong the life of the property, they must be capitalized. Treasury Regulations 111, Section 29.23(a)-4.

So here if the demolition of the building resulted in obtaining a longer lease or a lease for a greater rental,

there would be ground for arguing that the undepreciated cost of the building demolished could not be deducted but would have to be capitalized. However, in the instant case the demolition of the building did *not* result in increased rentals or an increased term of the lease. Hence, the full amount of demolition loss should, under the general rule of the regulations and cases, be allowed as a deduction in the year of demolition.

3. Where, after a lease has been entered into, it is necessary to demolish or dispose of property of the lessor, any loss incurred therein is deductible.

A distinction is drawn in the cases between those instances in which property is demolished in order to secure a lease (in which instances the loss may not be allowable) and those in which after a lease is entered into, events unanticipated at the time of the lease cause the property to be demolished or sold at a loss. In the latter situation, the loss constitutes an allowable deduction.

In *Commissioner v. Providence, Warren and Bristol R. R. Co.* (CA 2, 1935) 74 F. 2d 714 the difference between the cost of electric generators and the price for which they were sold at a loss in 1926 by the assignee of the taxpayer's lessee was held deductible as a loss to the taxpayer-lessor for that year.

In the *Providenc*e case, a provision in the lease permitted the lessee to dispose of "such portions and parcels of the real estate and property * * * not required by the lessee for railroad purposes." Under this provision, the lessee was accountable to the lessor-taxpayer only for the proceeds, if any, from the sale

or other disposition of the property. The Court held that when the generators were sold, the lessor was no longer protected by the general provision in the lease requiring the lessee to return the value of all property received in full, and the loss determined by the sale became the lessor's loss.

The *Providence* case was followed by the Board of Tax Appeals in *Mississippi River & Bonne Terre Railway* (1939) 39 BTA 995, where the facts were the same in all material respects. These two cases are in fact weaker than the instant case. There, while the exact property which might be sold by lessee was not known, it was at least contemplated that certain property might become valueless for railroad purposes. It could therefore be argued that the permission to dispose of such property was in effect given in consideration for the lease, and hence that the losses therefrom should be amortized over the period of the lease. Here, however, the parties did not realize when the lease was executed that the building would become valueless. Hence, it is even clearer that the claimed loss is allowable.

In *Terre Haute Electric Co., Inc. v. Commissioner* (CA 7, 1938) 96 F. 2d 383, the taxpayer in 1907 leased its property under a long-term lease. The property leased included interurban traction lines. In 1931 on the joint application of the taxpayer and its lessee, the Indiana Public Service Commission approved the abandonment of two lines which were wholly obsolete for the purposes of railway operation. The lease provided that the lessee would replace any property

which became worn out or was sold or otherwise disposed of.

The Court allowed to the lessor a loss for the abandonment of the two interurban lines, stating:

> "Thus the theory upon which a lessor, under a lease such as here involved, has been denied the right to claim deduction for depreciation, is, that by the terms of the lease the lessee has assumed the obligation of maintaining and operating the property in such a manner that it will be returned to the lessor at the expiration of the lease in as good condition as at the beginning, and, therefore, the lessor has sustained no loss. In this case, as we have pointed out, the petitioner, as lessor, has sustained no loss either by depreciation or obsolescence as that burden was assumed by the lessee and protects petitioner during the life of the lease.
>
> "We are unable to see any reason, however, why the contracting parties could not cancel a lease of this character, or any other character for that matter, and relieve themselves of the obligations incurred thereby, provided, of course, it was not to the injury of third parties. Here, apparently, the parties to the lease in 1931, agreed that two of the lines in question might be abandoned, and by proper state authority, were directed to be abandoned. Under such circumstances, how can it be said that the lessor is protected from the loss thus sustained? Certainly, thereafter, the lessee would be under no obligation to restore the abandoned property. It seems clear to us that petitioner sustained a deductible loss for the year 1931, on account of the two interurban railways abandoned that year * * *"

The facts of the *Terre Haute Electric Co.* case are substantially the same as those in the instant case. In neither case at the time that the lease was executed was there any intention of abandoning or demolishing any of the leased property; subsequent events in both instances made such abandonment or demolition advisable. In the instant case, it was necessary to modify the original lease in order to give the lessee the permission to demolish the building; in the *Terre Haute* case the Court considered the joint application of the lessor and the lessee in applying for the abandonment of the properties involved to constitute a modification of the lease provision which required the lessee to return the property in the condition in which it acquired it. The claimed loss should be allowed in this case just as the abandonment loss was allowed in the *Terre Haute Electric Co.* case.

4. The building in question became economically worthless during the taxpayer's fiscal year ended July 31, 1950.

In the instant case, the building in question became economically valueless during the taxpayer's fiscal year ended July 31, 1950. The building was considered useful when the lease was entered into on October 6, 1949, but later in the same fiscal year after the City refused permission to convert it into a garage in the manner contemplated by the lessee it became valueless and unsuitable for any purpose whatsoever. It was demolished not in order to secure a new lease or a new building, but because it was worthless. Under such circumstances, the demolition loss is deductible in full.

In *Commissioner v. Appleby* (CA 2, 1941) 123 F. 2d 700, *aff'g* (1940) 41 BTA 18, the property in question was inherited in 1913, and the building was demolished and a new one built in 1917. The new building was condemned in 1933 and the taxpayers were upheld by both the Board of Tax Appeals and the Circuit Court in including in their basis for the new building the undepreciated value of the old building, since the old building had been demolished with the purpose of constructing a new building. The Court of Appeals said by way of dictum:

> "* * * Losses are recognized only when they result from a closed transaction. *If a building is demolished because unsuitable for further use, the transaction with respect to the building is closed and the taxpayer may take his loss;* but if the purpose of demolition is to make way for the erection of a new structure, the result is merely to substitute a more valuable asset for the less valuable and the loss from demolition may reasonably be considered as part of the cost of the new asset and to be depreciated during its life, as is a broker's commission for negotiating a lease." [Emphasis supplied.]

In *Alice V. Gordon* (1942) 46 BTA 1201, *aff'd* (CA 4, 1943) 134 F. 2d 685, the Board of Tax Appeals found that certain improved real property in which the taxpayer had an undivided interest became worthless in 1937 and accordingly allowed her to deduct the amount of the loss in that year even though she retained legal title to the property throughout the year. The Board said:

> "* * * it is clear that in the year 1937 petitioner's interest in the real property under consideration became worthless; that it was then properly deductible as a loss; and that the action by respondent in disallowing it must be disapproved. In *Young v. Commissioner* (CA 9, 1932) 59 F. 2d 691, *cert. den.* 287 US 652, this Court said:
>
> "* * * There can be no question that where a land owner finds it necessary to remove structures unsuitable for further use, he may have a deduction from gross income for the loss."

Compare also *Jack M. Chesbro* (1953) 21 TC 123, *aff'd on other issues* (CA 2, 1955) ....F. 2d .... The regulations, too, approve this rule. Regulations 111, Section 29.23(e)-3 provides in part as follows:

> "LOSS OF USEFUL VALUE.—When, through some change in business conditions, the usefulness in the business of some or all of the assets is suddenly terminated, so that the taxpayer discontinues the business or discards such assets permanently from use in such business, he may claim as a loss for the year in which he takes such action the difference between the basis (adjusted as provided in section 113(b) and sections 29.113(e)(14)-1 and 29.113(b)(1)-1 to 29.113(b)(3)-2, inclusive) and the salvage value of the property. This exception to the rule requiring a sale or other disposition of property in order to establish a loss requires proof of some unforeseen cause by reason of which the property has been prematurely discarded, as, for example, where an increase in the cost or change in the manufacture of any product makes it necessary to

> abandon such manufacture, to which special machinery is exclusively devoted, or where new legislation directly or indirectly makes the continued profitable use of the property impossible. This exception does not extend to a case where the useful life of property terminates solely as a result of those gradual processes for which depreciation allowances are authorized. It does not apply to inventories. The exception applies to buildings only when they are permanently abandoned or permanently devoted to a radically different use, and to machinery only when its use as such is permanently abandoned. * * *"

The evidence shows that there was no salvage value in the instant case (R. 124).

The facts in *Work Clothing Corp.* (1949) 8 TCM 506 are very similar to those of the instant case. There, taxpayer acquired certain improved property with several old brick buildings thereon for the purpose of converting the existing structures on the property into a public market. After acquisition of the property, the original plan proved impracticable and taxpayer decided to turn a portion of the property into a parking lot, which required demolition of some of the buildings. It was held that taxpayer was entitled to deduct the cost of the buildings demolished less depreciation and less salvage. The Court said:

> "The record clearly shows that the property was bought by the petitioner for the purpose of converting it into a public market; the petitioner at that time had no intention of demolishing any of the buildings; efforts were made to follow out

> the original purpose; it was later found that the original plans were not feasible; and the petitioner was required to change its plans and adapt the property to another purpose which required demolition of some of the buildings. It follows that the petitioner is entitled to deduct the cost of the buildings, less depreciation up to the time when demolition was begun and less salvage."

Even assuming that the amendment of the lease by the letter agreement of April 24, 1950, is considered as a new lease secured by granting permission to the lessee to demolish the building, nevertheless, under the facts of the instant case, amortization of the remaining cost of the building would not be required, but rather such remaining cost would be allowable as an ordinary deduction. In *Smith Real Estate Co. v. Page* (CA 1, 1933) 67 F. 2d 462, the Court said:

> "The correct conclusion depends, as it seems to us, on the facts in the particular case. If the existing buildings had become valueless at the time of the lease, it is probably false to the fact to say that the lessee paid, in any form or guise, compensation for them. Under such circumstances, the loss on the buildings had already occurred when the lease was made. It was not yet deductible for income tax purposes because no steps had been taken to fix it. But the transfer of the buildings to the lessee would have that effect, and would make the loss immediately deductible. On the other hand, if the buildings had value at the time of the lease, such value was surrendered to the lessee and was presumably compensated by the provisions in the lease. * * *"

The Court in the *Smith* case held that the taxpayer had not proved that the property concerned had no value at the time of the lease and demolition. Accordingly, it held that the loss was not deductible, although stating that the loss would have been deductible had the fact that the property concerned had no value been satisfactorily established. Worthlessness is clearly evident in the instant case; when, shortly prior to the lease modification in question, the City and County of San Francisco refused to approve the plans for the conversion of the property involved into a five-story garage, the building became worthless and was so considered by both the taxpayer and the lessee (R. 123, 138). Thus, even if the modification of the lease which took place on April 24, 1950, were considered the same as entering into a new lease and acquiring for the taxpayer an asset in substitution for the building which the lessor had permitted the lessee to demolish, nevertheless, since the building was obsolescent and had no value whatsoever at the time of the lease modification, under the *Smith Real Estate Co.* case, the loss is deductible by taxpayer in its fiscal year ending July 31, 1950.

D. To allow the claimed deduction would not give the taxpayer a ''windfall'' unintended by Congress.

At the end of its opinion, The Tax Court states (R. 98-99):

> ''The facts in this case are unusual, but from whatever point of view the problem is studied, we are led inevitably to the conclusion that petitioner did not in fact sustain a loss as a result of the

> destruction of the theatre building, and that to allow the claimed deduction here would be to give petitioner a windfall that Congress never intended."

The Tax Court's conclusion that the taxpayer did not sustain a loss is erroneous and its conclusion that to allow a deduction would result in a "windfall" to the taxpayer is equally erroneous. At the time of its demolition, the Tivoli Theatre Building had an unrecovered cost or basis of $132,284.42 (R. 92). After the demolition, the taxpayer had no building. Plainly, from an every day "common sense" viewpoint, taxpayer sustained a loss upon the demolition of the building. The question in this case is not whether the $132,284.42 unrecovered cost or basis of the Tivoli Theatre building at the time of its demolition may be deducted at all; the only question is whether this amount may be deducted in the year of demolition, as the taxpayer maintains, or whether it must be spread over the term of the lease, as the Commissioner contends.

Neither the rule sought by the taxpayer nor the rule contended for by the Commissioner and approved by The Tax Court results in a "windfall" to either taxpayers generally or the Commissioner. The effect of either rule in any particular case depends on the income of the particular taxpayer and the rates of taxation during the years of the lease in question. The effect of either rule on the revenue is unpredictable. Hence there is no reason for stating that allowing the

deduction in the manner claimed by the taxpayer would give it a "windfall".

Nor can it be said that Congress intended to deny deductions of the sort here in question. On the contrary, Section 23(f) of the Internal Revenue Code of 1939 specifically permits the deduction by a corporation of "losses sustained during the taxable year and not compensated for by insurance or otherwise."

Throughout its opinion, The Tax Court expresses its doubt that the taxpayer here actually sustained a loss on the demolition of the building. For example, it remarks that (R. 98):

> "* * * Indeed, the razing of the building may well have constituted a benefit rather than a detriment to petitioner. The evidence suggests that the building was obsolete or obsolescent, and the rather substantial cost of demolition was borne by the lessee."

It also states that (R. 98-99):

> "* * * we are led inevitably to the conclusion that petitioner did not in fact sustain a loss as a result of the destruction of the theatre building * * *"

The Tax Court overlooks the distinction between an economic loss and a realizable taxable loss. For example, *A* purchases certain stock in 1954 for $100,000. On January 1, 1956 this stock is worth only $1,000, and *A* sells it for that amount. In a sense, he has incurred no economic loss by reason of the sale. Immediately before the sale he had stock worth $1,000;

immediately thereafter he has $1,000 in cash. He is no richer and no poorer. Actually, his economic loss has occurred in the preceding years as the stock depreciated in value. Yet, for income tax purposes, his loss is not "realized" until the stock is sold or becomes completely worthless. And the loss, for income tax purposes, is not deductible until 1956.

Here, too, the economic loss may have occurred before the actual demolition of the building; indeed if the building had any value, the taxpayer would not have so readily consented to its demolition. The taxpayer submits, however, that for income tax purposes, his loss was realized and incurred in its fiscal year ended July 31, 1950, the year in which the building became worthless, in which the lessee was given permission to demolish it, and in which the actual demolition occurred.

The Tax Court suggests (R. 98), that "the razing of the building may well have constituted a benefit rather than a detriment to petitioner". However, this does not prevent the deduction of the loss. If a taxpayer purchases a business and consistently loses money on it, his sale of that business at a loss might well be an economic benefit to him. Yet, the excess of his adjusted basis (cost) over the proceeds of the sale would nonetheless certainly constitute a deductible loss to him for income tax purposes. Similarly, here it is immaterial whether the taxpayer was economically better off before or after the demolition of the building. Before the demolition, the taxpayer had a building with an undepreciated cost basis

of $132,284.42; after the demolition, the taxpayer had no building and had no asset which it had not had prior to demolition of the building. We submit that under such circumstances, it is clear that taxpayer's loss was realized for income tax purposes in its fiscal year ended July 31, 1950 and that the claimed loss should be allowed in full as a deduction in that fiscal year.

CONCLUSION.

The decision of The Tax Court is erroneous and should be reversed.

Dated, San Francisco, California,
January 24, 1956.

Respectfully submitted,
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(Appendix Follows.)

Appendix.

Appendix

INTERNAL REVENUE CODE OF 1939.

Section 23. *Deductions from Gross Income.*

In computing net income there shall be allowed as deductions: * * *

(f) *Losses By Corporations.*—In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise.

Section 117(j). *Gains and Losses From Involuntary Conversion and From the Sale or Exchange of Certain Property Used in the Trade or Business.*—*

(1) Definition of Property Use in the Trade or Business.—For the purposes of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

(2) General Rule.—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion

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*Section 117(j) is quoted in the form in which it existed in the taxable year involved in this proceeding.

(as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. For the purposes of this paragraph:

(A) In determining under this paragraph whether gains exceed losses, the gains and losses described therein shall be included only if and to the extent taken into account in computing net income, except that subsections (b) and (d) shall not apply.

(B) Losses upon the destruction in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion.

TREASURY DEPARTMENT REGULATIONS 111.

Sec. 29.23(f)-1. *Losses by Corporations.* Losses sustained by domestic corporations during the taxable year and not compensated for by insurance or otherwise are deductible insofar as not prohibited or limited by sections 23(g), 23(h), 24(b), 112, 117, 118,

and 251. The provisions of sections 29.23(e) to 29.23(e)-5, inclusive, and section 29.23(i)-1 are in general applicable to corporations as well as individuals. See section 232 as to deductions by foreign corporations. For special provisions with respect to war losses, see section 127.

Sec. 29.23(e)-2. *Voluntary removal of buildings.* Loss due to the voluntary removal or demolition of old buildings, the scrapping of old machinery, equipment, etc., incident to renewals and replacements is deductible from gross income. When a taxpayer buys real estate upon which is located a building, which he proceeds to raze with a view to erecting thereon another building, it will be considered that the taxpayer has sustained no deductible expense on account of the cost of such removal, the value of the real estate, exclusive of old improvements, being presumably equal to the purchase price of the land and building plus the cost of removing the useless building.

Sec. 29.23(e)-3. *Loss of useful value.*—When, through some change in business conditions, the usefulness in the business of some or all of the assets is suddenly terminated, so that the taxpayer discontinues the business or discards such assets permanently from use in such business, he may claim as a loss for the year in which he takes such action the difference between the basis (adjusted as provided in section 113(b) and sections 29.113(a)(14)-1 and 29.113(b)(1)-1 to 29.113(b)(3)-2, inclusive) and the salvage value of the property. This exception to the rule requiring a sale or other disposition of prop-

erty in order to establish a loss requires proof of some unforeseen cause by reason of which the property has been prematurely discarded, as, for example, where an increase in the cost or change in the manufacture of any product makes it necessary to abandon such manufacture, to which special machinery is exclusively devoted, or where new legislation directly or indirectly makes the continued profitable use of the property impossible. This exception does not extend to a case where the useful life of property terminates solely as a result of those gradual processes for which depreciation allowances are authorized. It does not apply to inventories. The exception applies to buildings only when they are permanently abandoned or permanently devoted to a radically different use, and to machinery only when its use as such is permanently abandoned. Any loss to be deductible under this exception must be fully explained in the return of income. The limitations provided in section 117 with respect to the sale or exchange of capital assets have no application to losses due to the discarding of capital assets.

If the depreciable assets of a taxpayer consists of more than one item and depreciation, whether in respect of items or groups of items, is based upon the average lives of such assets, losses claimed on the normal retirement of such assets are not allowable, inasmuch as the use of an average rate contemplates a normal retirement of assets both before and after the average life has been reached and there is, therefore, no possibility of ascertaining any actual loss under

such circumstances until all assets contained in the group have been retired. In order to account properly for such retirement the entire cost or other basis of assets retired, adjusted for salvage, will be charged to the depreciation reserve account, which will enable the full cost or other basis of the property to be recovered.

In cases in which depreciable property is disposed of due to causes other than exhaustion, wear and tear, and normal obsolescence, such as casualty, obsolescence other than normal, or sale, a deduction for the difference between the basis of the property (adjusted as provided in section 113(b) and sections 29.113(a)(14)-1, and 29.113(b)(1)-1 to 29.113(b)(3)-2, inclusive) and its salvage value and/or amount realized upon its disposition may be allowed subject to the limitations provided in the Internal Revenue Code upon deductions for losses, but only if it is clearly evident that such disposition was not contemplated in the rate of depreciation.

In the case of classified accounts, if it is the consistent practice of the taxpayer to base the rate of depreciation on the expected life of the longest lived asset contained in the account, or in the case of single item accounts if the rate of depreciation is based on the maximum expected life of the asset, a deduction for the basis of the asset (adjusted as provided in section 113(b) and sections 29.113(a)(14)-1 and 29.113(b)(1)-1 to 29.113(b)(3)-2, inclusive) less its salvage value is allowable upon its retirement. (See sections 29.23(l)-1 to 29.23(l)-10, inclusive.)